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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

QUESTION PRESENTED

Whether respondent's *redemption*, through the one-for-one exchange of its 5 percent, 18 year, sinking fund debentures in the face amount of $50.00 for each share of its outstanding $50.00 par, 5 percent cumulative preferred stock with a fair market value of $33.00, gave rise to amortizable original issue bond discount on each debenture in the amount of $.95 per year or an additional 1.9 percent annual interest.

STATUTES AND REGULATIONS INVOLVED

Those code sections[1] and regulations set forth by the petitioner are pertinent to this case, however, petitioner has failed to clearly distinguish which code sections and regulations dealing with original issue bond discount were in effect in 1957 when the exchange transaction in this case occurred and during the period up to and including 1967 when the respondent's deductions for discount were subsequently disallowed. Furthermore, the petitioner has failed to set forth the pertinent provisions of Sections 302, 311 and 317 of the Code which deal with redemptions. The applicable code section, Section 163(a), and regulation, Treasury Regulation on Income Tax Section 1.61-12(c)(3), dealing with original issue bond discount as they appeared in 1957 and during the period up to and including 1967, as well as the pertinent portions of Sections 302, 311 and 317 dealing with redemptions are set forth in the text of respondent's argument which follows as well as in Appendix A, *infra*, pp. 35-38.

STATEMENT

The respondent, National Alfalfa Dehydrating and Milling Company (hereinafter referred to as "NAD"), was incorporated on May 4, 1946 under the laws of the State of Delaware, and engages in the business of milling and dehydrating alfalfa. (R. 24, 188)[2] NAD was initially capi-

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1. All references to the Code or sections of the Internal Revenue Code stated herein are references to the Internal Revenue Code of 1954 unless otherwise stated.

2. "R." references are to the separately bound record appendix. "Pet. App." references are to the Appendices to the petition for certiorari to which reference has also been made by the petitioner.

talized with preferred stock as well as common stock. (R. 125, 189) Prior to the exchange of its debentures for its outstanding preferred stock, which occurred in 1957 and which is the transaction under analysis here, NAD had 47,059 shares of $50 par, 5 percent cumulative preferred stock outstanding. (R. 25) Due to NAD's poor financial condition, dividends on that preferred stock were significantly in arrears. (R. 25) The preferred stock was trading in the over-the-counter market at $33.00 per share just prior to the exchange. (R. 161, 167)

NAD, in hopes of improving its financial picture and increasing its earnings, decided in 1957 to expand into more profitable eastern markets. (R. 25) NAD found, however, that its credit rating was so poor, due in part to the dividend arrearages, that it could not obtain lines of credit from lenders necessary to allow expansion into the eastern markets. Therefore, in order to accomplish the expansion it was necessary for NAD to attempt to improve its financial picture. Thus, in July, 1957, NAD redeemed its outstanding preferred stock through an exchange of its new debentures for the outstanding preferred stock and an exchange of warrants (to purchase NAD's common stock) for the dividend arrearages. To further strengthen the equity section of its balance sheet NAD exchanged new $3.00 par value common stock for its outstanding $1.00 par value common stock. (R. 57)

Fidelity-Philadelphia Trust Company agreed to transact the exchanges and to act as the Trustee under an Indenture for the debentures. Fidelity-Philadelphia Trust Company, prior to the exchanges, requested and received a ruling letter dated May 29, 1957 from the Treasury Department on the tax effects of the proposed exchanges. (R. 17-21) The request for the ruling had sought that all

of the exchanges should be treated as tax-free. The ruling letter, however, stated that although the exchange of the $3.00 par value common stock for the outstanding $1.00 par value common stock was a tax-free reorganization under Section 368(a)(1)(E) of the Code, the exchange of the debentures for the outstanding preferred stock was a redemption and therefore a taxable exchange under Section 302(a) of the Code. The pertinent portion of that ruling with respect to the exchange of the debentures for the outstanding preferred stock provided as follows:

> (3) Assuming but not determining that the 5% debenture bonds to be issued qualify as securities (create a genuine relationship of debtor and creditor), gain or loss will be recognized to the preferred stockholders from the exchange of 5% cumulative preferred stock, par $50., and the dividend arrearage thereon of $10. per share as of June 1, 1957, for debenture bonds and warrants to subscribe for the new common stock at $10. per share (section 302(a)). The gain or loss recognized from the exchange will be measured by the difference between the cost or other adjusted basis of the preferred stock surrendered and the fair market values of the debentures and warrants received and such gain or loss will constitute capital gain or loss subject to the applicable provisions and limitations of subchapter P Part I of Subtitle A of the Code.
>
> The basis of the debentures and warrants received by the holders of the old preferred stock will be the fair market values used in the determination of the recognizable gain or loss. (R. 20-21)

On the date of the exchange each share of preferred stock had a fair market value of $33.00. (R. 161, 167) The warrants were of negligible value. (R. 168)

The debentures differed materially from the preferred stock which was retired after the exchange. The debentures contained a specific maturity date and represented a binding, unconditional and legal obligation on the part of NAD to pay interest and principal. (R. 77, 154) Under the terms of the Indenture (R. 67) NAD was required to annually contribute a fixed amount to a sinking fund in order to redeem the debentures. (R. 100-102) The debentures were subordinated under the Indenture,

> only to current bank borrowings for inventory purposes which obligations mature by their original terms in less than twelve months and obligations of the Company [NAD] to suppliers of materials, services and labor incurred in the normal course of the Company's business and reasonably required in its operations, which obligations are due and payable when billed, and to any existing liens, encumbrances, mortgages, conditional sales agreements, or pledges, or any replacement, renewal, or extension thereof. . . . (R. 100)

and, unless the consent of the holders of at least 66⅔ percent of the debentures outstanding was obtained, the debentures could not be subordinated to any funded debt created, issued, assumed, or guaranteed by NAD or any subsidiary thereof. (R. 92-93)

The debentures and the underlying Indenture contained many other provisions for the protection of the priority of the debentures and the rights of the debentureholders. In part these included restrictions on the operations of NAD. (R. 93-95) The Indenture also set forth the debentureholders' remedies in the event that NAD defaulted on any of its obligations to pay interest or principal. (R. 108-117) In all respects the debentureholder was a

creditor of NAD rather than an owner which he had been when he held the preferred stock.[3]

In its income tax returns for the fiscal years ending April 30, 1958 through April 30, 1967, NAD claimed deductions for the additional interest paid by reason of amortizable original issue bond discount on the debentures which resulted from the difference between the face value of the debentures ($50.00) and the fair market value of the debentures on the date of issue ($33.00). (R. 27) Because the ruling letter (R. 17-21) required the fair market value of the preferred stock ($33.00) to be used in recognizing gain or loss to the preferred stockholders, NAD used that value ($33.00) in determining the fair market value of the debentures on the date of issue. The deductions for discount included both the amount amortized on a straight line basis spread over the 18 year prospective lives of the debentures as well as the unamortized discount on debentures repurchased or redeemed each year.[4] (R. 28) The deductions for the discount in the years 1958 through 1966 were included in loss carry-forwards to the fiscal year ended April 30, 1967. (R. 15-16)

The petitioner disallowed the interest deductions taken by NAD for the fiscal year ended April 30, 1967 in the amount of $109,804.00 and also disallowed $321,657.00 of interest deductions attributable to the fiscal years ending April 30, 1958 through April 30, 1966 as carried forward and deducted in the return for the year ended April 30,

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3. As a creditor of NAD the debentureholder was not an equity owner. He had no residual interest in the corporation or the profitability of the corporation. For financial statement purposes the debt owed him was reflected in the "Liability" section of the balance sheet while the residual interests of the stockholders were reflected in the "Owners' Equity" section of the balance sheet. (R. 157)

4. This straight line amortization of the discount resulted in additional interest on each debenture of $.95 per year or an additional 1.9% of interest per year. Effectively, NAD was paying 6.9% interest rather than the stated interest of 5%.

1967. The disallowance resulted in a deficiency which was assessed by petitioner. (R. 13-16) The deficiency was upheld by the United States Tax Court which, in its opinion (Pet. App. A 18-41), refused to follow the authoritative and binding decision of the Court of Appeals for the Tenth Circuit in *Atchison, Topeka and Santa Fe R. Co.* v. *United States*, 443 F.2d 147 (10th Cir. 1971). NAD appealed the decision of the Tax Court, and the Court of Appeals reversed the Tax Court (Pet. App. B 42-69) pointing out that the Tax Court had ignored the economic realities surrounding the exchange wherein the discount arose. The Court of Appeals in its opinion properly differentiated between what occurs in an exchange where gain or loss is recognized and what occurs in a transaction where discount arises. The Court of Appeals also explained the confusion apparent in several Court of Claims' decisions in which that Court had equated a loss with an interest expense.

SUMMARY OF ARGUMENT

I.

Code Section 163 providing for the deduction of interest expense and Treasury Regulation on Income Tax Section 1.61-12(c)(3) which permitted deductions of interest in the form of amortized bond discount were the primary guides for NAD in 1957 and up to and including 1967 for determining the propriety of NAD's bond discount deductions. These guides were silent on the subject of what constituted bond discount. However, the pertinent case law existing in 1957 and the economic realities of NAD's exchange of its debentures for its outstanding preferred stock clearly indicated that NAD incurred deductible bond discount in the exchange in the amount by which the total of the face amount of each debenture ($50.00) exceeded the issue price of the

debenture ($33.00). The $17.00 of discount represented part of the cost to NAD of using the preferred stockholder's $33.00 which was needed by NAD to purchase the preferred stock, a cost which NAD would not have incurred had it had $33.00 of ready cash to make the purchase.

II.

Interest expense or discount may be incurred by a taxpayer only in connection with debt obligations. Under virtually every possible standard established for determining whether a security is a debt obligation or an equity security as found in cases on the subject, NAD's debentures meet the criteria of debt obligations. After the 1957 exchange, the debentureholders were solely and exclusively creditors of NAD and they were not equity owners in NAD as they had been before the exchange when they were preferred stockholders. In contrast, the income debentures in *Erie Lackawanna R. R. Co.* v. *United States*, 422 F.2d 425 (Ct. Cl. 1970), relied upon by petitioner, appear to have been actually equity instruments nearly identical to the preferred stock for which they were exchanged.

III.

NAD's issuance of its debentures in the 1957 exchange constituted a redemption by NAD of the preferred stock under Code Sections 302, 311(a) and 317(b), and the exchange was not a tax-free recapitalization under Section 368(a)(1)(E). The ruling letter issued by the Treasury Department prior to the exchange specifically characterized the exchange of the debentures for the preferred stock as a redemption and not a tax-free recapitalization, and it required the parties to the exchange to recognize gain or loss on the exchange in accordance with the redemption sections. The redemption sections required the parties to the

exchange to accept the fair market value of the preferred stock on the date of the exchange ($33.00) as the issue price of the debentures.

IV.

The Court of Appeals properly recognized that to NAD the $17.00 difference between the face amount of the debentures and the issue price of the debentures represented interest expense in the form of discount and not a loss on the exchange. The Court of Claims, on the other hand, in the *Erie Lackawanna* case, *supra*, and those other cases relying on it has failed to recognize the distinction between gain or loss resulting from a redemption, an exchange transaction, and the interest expense incurred by a buyer, such as NAD, making a purchase without ready cash. The Court of Appeals' analogy of the NAD exchange to one where the corporation sold its $50.00 face amount debentures for $33.00 cash to obtain funds to redeem the outstanding preferred stock is appropriate not only as an analogy but because it clearly reflects the economic realities of the exchange which actually occurred. Among those economic realities were that the preferred stockholders acted as a "financing medium" in the exchange and that a $17.00 discount on a $50.00, 18 year 5 percent debenture resulted in an effective interest rate on the debenture of 6.9 percent or $3.45 annual interest, deductible to NAD and reportable as ordinary income by the debentureholder.

V.

The petitioner has adopted the Court of Claims' analysis in *Erie Lackawanna*, *supra*, and refers to that analysis as the "arithmetical equivalence" theory. NAD understands that phrase to mean that a debenture is the same as a share of preferred stock. However, in view of the many substantial distinctions between NAD's debentures and its preferred

stock, it appears that the use of the phrase "arithmetical equivalence" and the analysis it stands for, if applied to the case at bar, is merely an easy means of avoiding the task of analyzing the economic realities of the exchange and the totally distinct nature of the securities involved. Moreover, the weight to be accorded the decision in the *Erie Lackawanna* case must be minimal in view of its heavy reliance on *Union Pacific R.R.* v. *United States*, 401 F.2d 778 (Ct. Cl. 1969), cert. denied 395 U.S. 994 (1969) which was a case involving the application of the World War II excess profits tax provisions to a transaction wherein Union Pacific had issued common stock for outstanding convertible debentures, a situation bearing no resemblance to the facts in the case at bar.

ARGUMENT

I. The Applicable Code Section, Regulation and Case Law in Effect Between 1957 and 1967, When the Transaction Here Involved Occurred and the Interest Deductions Were Taken, Clearly Authorized NAD's Deductions for Amortized Original Issue Bond Discount.

In 1957 when the exchange transaction involved in this case took place, and during the period between 1958 and 1967, which coincides with that period of time when the interest deductions were taken by NAD, Section 163 of the Code and Section 1.61-12(c)(3) of the Treasury Regulations on Income Tax were the guides for taxpayers in determining the propriety of bond discount deductions.[5] Those sections provided in pertinent part as follows:

> Sec. 163. [Interest] (a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.
>
> * * * *
>
> Income Tax Regulations Sec. 1.61-12 * * * *
>
> (c) * * * *
>
> (3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. . . .
>
> * * * *

5. During the period 1957 to 1967, regulations under Section 163 with regard to bond discount were nonexistent. Reg. Section 1.61-12(c)(3) had been adopted in 1957 and subsequently was amended and reclassified under Section 163 in 1968. When the reclassification occurred in 1968 for the first time there was included a reference to Section 1232 regulations. This reference, however, is made only to adopt a definition as set forth in the Section 1232 regulations and does not adopt those regulations as a whole.

These provisions failed to adequately state the criteria for determining what constituted bond discount. However, the case law during this period and the economic realities involved in the issuance of debt securities, such as NAD issued, clearly dictated that the difference between the face value of a bond and the issue price of that bond represented bond discount.[6] In a non-cash exchange[7] such as NAD had, it was absolutely necessary to look to the economic facts surrounding the exchange transaction and analyze the economic realities of that situation in order to determine whether discount arose. The case law at the time stated that bond discount represented the expense of borrowing. It served "the same function as stated interest"[8] and "represents a part of the cost of the borrowed capital."[9] As set forth and aptly described in Judge (now Justice) Marshall's well reasoned opinion in *Nassau Lens Co.* v. *Commissioner*, 308 F.2d 39 (2d Cir. 1962), rev'g the United States Tax Court, 35 T.C. 268 (1960), a case decided subsequent to the 1957 exchange by NAD but long prior to 1967 when the deductions were disallowed by petitioner,

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6. NAD contends that even had Reg. Section 1.163-3(a) been in effect during the period in question, the same result, the deduction of amortized discount over the life of the debenture as interest expense, would have resulted. Section 1232 now controls the debentureholder's reporting of discount income, while Section 163 continues to control the deduction for the issuing corporation. The reference to Reg. Section 1.1232-3(b)(2) in Reg. Section 1.163-3(a) is limited to the adoption of the definition of bond discount as found in that provision. Therefore, any reference to Section 368 as found in Section 1232 is inapplicable to the issuing corporation, as is the bulk of Section 1232.

7. The problem of bond discount in exchanges of bonds for property was met head-on in *American Smelting and Refining Co.* v. *United States*, 130 F.2d 883 (3rd Cir. 1942). There the court held that discount did arise in such a transaction.

8. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57 (1965).

9. *Helvering* v. *Union Pacific R.R. Co.*, 293 U.S. 282, 287 (1934).

discount payments represent the cost of using someone else's money.

In the opinion in *Nassau Lens*, the Court stated:

> It may well be true that a 'borrowing buyer's' interest or discount payments seem part of the cost of property. In reality, however, they are the cost of using money which is needed to purchase the property, a cost not incurred by a buyer with ready cash. This distinction is clearly recognized by the code, and we feel that we must give effect to it . . . . The contention asserted [by the Commissioner] is merely that when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money. We find no support for such an assertion and reject it. *Id.* at 44.

Petitioner suggests in his brief[10] that the issue in this case is whether discount may arise in a financial reorganization, but, as the opinion in *Nassau Lens* indicates, the true issue is whether the preferred stockholders of NAD acted as a "financing medium" in the exchange and consequently the discount incurred by NAD on its debentures represented the excess expense incurred by NAD due to NAD's inability to pay cash to the preferred stockholders at the time of the exchange.[11] The majority opinion of the Court of Appeals clearly recognized this to be the issue in this case and decided that discount was incurred in the exchange and properly deducted by NAD.

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10. See Petitioner's Brief pp. 23-24.

11. The balance sheets for April 30, 1957 and 1958, as attached to the income tax return of NAD for the fiscal year ended April 30, 1958 (R. 30), clearly show that NAD did not have the necessary cash or other liquid assets to redeem the preferred stock, which was outstanding, in any manner other than by using the discounted debentures.

II. Discount and the Resulting Deduction for Interest Arise Only in Connection with Debt Obligations and Not in Connection with Equity Securities.

In every case involving a determination as to whether an interest deduction is appropriate, it is necessary to analyze the underlying security to determine if it is properly classified as a debt obligation.[12] The Supreme Court in analyzing the distinctions between debt and equity securities has held, in a case where debentures were issued for stock, that certain criteria may be utilized to determine if debentures are actually debt instruments. In *John Kelley Co.* v. *Commissioner*, 326 U.S. 521 (1946) this Court stated that debt securities reflect:

> . . . a promise to pay a certain annual amount, if earned, a priority for the debentures over common stock, . . . [assignability] without regard to any transfer of stock and a definite maturity date in the reasonable future. *Id.* at 526.

Basing its opinion on these given indicia of debt securities the Court found the obligations in question to be debt obligations upon which interest could properly be incurred and deducted by the issuing corporation.

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12. See *Lantz Co., Inc.* v. *United States*, 424 F.2d 1330 (9th Cir. 1970); *Gilbert* v. *Commissioner*, 262 F.2d 512 (2d Cir. 1959), cert. denied 359 U.S. 1002 (1959); and *Gordon Lubricating Co.*, 24 TCM 697 (1965). Recognizing the possible difficulties in distinguishing between debt and equity securities, Congress in 1969 authorized the Commissioner to issue regulations in this area. Section 385. Congress provided therein guidelines which the Commissioner could utilize. However, the Commissioner to this date has not issued proposed regulations.

NAD's debentures likewise are clearly debt obligations[13] having been issued in the form of 18 year, 5 percent, sinking fund debentures. The debentures carried an unconditional obligation on the part of NAD to pay interest. (R. 77, 154) The stated rate of interest for which NAD was liable was 5 percent. (R. 76, 77, 154) The stated interest was required by the terms of the debenture to be paid semi-annually. In the event the interest was not paid there was a default under the terms of the Indenture. (R. 108) In contrast the dividends on the previously outstanding

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13. The criteria for this determination are derived from *John Kelley Co.* v. *Commissioner, supra,* and later cases including *O. H. Krause Grain and Milling* v. *Commissioner,* 279 F.2d 123 (9th Cir. 1960), and *Gordon Lubricating Co., supra.* In *Gordon Lubricating Co., supra* note 12, at 710, the following determinative factors are set forth:

> (1) The form of the debentures, including a fixed reasonable date of maturity, interest rate, and an unqualified promise to pay both principal and interest.
>
> (2) Priority and nature of the claim in case of default in payment of interest and principal, including extent of subordination contemplated or provided for.
>
> (3) The capital structure of the corporation, especially as it relates to the type of business involved.
>
> (4) Provision for establishment of a sinking fund, and the extent to which the sinking fund is used to retire outstanding debt obligations.
>
> (5) The nature of the risk involved, and the possibility of repayment regardless of earnings and profits.
>
> (6) Whether debentures are issued pro rata to stockholders, and the degree of control in management available to debentureholders.
>
> (7) Whether outside lenders, who are not interested in the profits or increase in equity of the corporation, would loan money under similar circumstances.
>
> (8) The intent of the parties, and the reasons for issuing debentures.
>
> (9) Whether there was a business purpose for financing through the use of debentures rather than stock, or whether this form of investment was used primarily for tax avoidance purposes.

It is apparent from a review of these standards that NAD's debentures were debt obligations.

preferred stock, unlike interest, could legally be paid only if there existed earnings and profits.

There existed a fixed maturity date on the debentures in the reasonably near future as the debentures were to mature in 18 years or in 1975.[14]

The distinction between debt and equity securities has often been based on whether the holder thereof maintained a continuing interest in the corporation. NAD's debenture-holders lost all financial interest in the corporation in not more than 18 years, a relatively short period of time.[15]

The debentures were subordinated only to bank loans made for inventory purposes and to obligations of NAD to suppliers of materials, services and labor incurred in the normal course of business. (R. 100) Therefore, the preferred stock was replaced with a higher preference security in that NAD, unlike before the 1957 exchange, incurred a debt that it was unconditionally required to pay regardless of its earnings and profits. The assets of NAD backed the debentures. To the extent that there were creditors to which these debentures were not subordinated, and there

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14. As of this date all of the debentures have been retired.

15. This 18 year term of NAD's debentures contrasts with the 65 year income debentures found in *Erie Lackawanna R.R. Co.* v. *United States*, 422 F.2d 425 (Ct. Cl. 1970) relied upon by the petitioner and the dissenting judge in the Court of Appeals. NAD believes that the only way the result in *Erie* could be considered as proper is if the Court of Claims actually determined that the debentures there were not debt obligations but equity securities. The overly lengthy term of the debentures, the fact that their interest provisions paralleled the preferred stock dividend restrictions (the preferred stock carried a 5% annual dividend, cumulative to the extent of 15%, while the debentures carried a 5% interest rate, payable only if earned and cumulative to the extent of 15%. *Erie, Id.* at n.4) and the I.C.C.'s report indicating that the exchange made by Erie was done for the purpose of obtaining a reduction in Erie's income taxes (*Erie, Id.* at n.12) lead to the conclusion that the income debentures involved in *Erie* were actually equity instruments and that the exchange constituted a tax-free reorganization.

did exist such classes of creditors, and that there were assets available, the debentures were secured by the assets of NAD both as to payment of principal and interest until they were retired or redeemed. (R. 108)

The debentures and the Indenture required the establishment of a sinking fund to assure redemption of the debentures. The sinking fund was maintained by the trustee. NAD at all times met the requirements of the sinking fund and the debentures were retired on schedule. (R 28)

While many mechanical standards for determining whether an instrument is debt or equity exist,[16] the Second Circuit's standard in *Nassau Lens*[17] of "substantial economic reality" appears to be as good an approach as has been devised for making an appropriate determination.[18] The "economic realities" in this case are found in the fact that when the preferred stockholders became debenture holders they lost their voice in the corporate policy decisions and lost their residual interest in the corporation and its future profitability. They found themselves no longer subject to the risks which they had previously experienced as equity owners in NAD and they were guaranteed a return on their investment irrespective of current or accumulated earnings and profits. These factors when viewed as a whole make for a clear showing that the instruments issued were debt instruments on which original issue bond discount could and did arise.

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16. See note 13 of this Brief.

17. *Nassau Lens Co.* v. *Commissioner, supra.*

18. Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (3rd Ed. 1971) at 4-14, 4-15.

III. The Issuance of the Debentures in Exchange for the Preferred Stock Constituted a Redemption.

NAD believes that Congress clearly intended for an exchange such as occurred here of debentures for outstanding preferred stock to be treated as a redemption. The exchange entirely removed the preferred stockholders from their status as equity owners in the corporation.[19]

Section 317(b) of the Code defines a stock redemption as follows:

> . . . stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in an exchange for property. . . .

"Property" as used in Section 317(b) is defined in Section 317(a) as an all-inclusive item which excludes stock of the corporation making the distribution.[20] "Securities" such as debentures are specifically included as property. NAD clearly effected a redemption by acquiring its preferred stock in exchange for "property," its debentures, as described in Section 317(b).

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19. Under Section 302(a) a redemption occurs in cases such as this unless the distribution of the debentures is "essentially equivalent to a dividend." Cf. *Bazley* v. *Commissioner*, 331 U.S. 737 (1947). In *Bazley* the exchange of debentures for outstanding preferred stock in no way affected the preferred stockholder's equity interest in the corporation. The preferred stock and the common stock were both held proportionately by the same stockholders and therefore the exchange of the debentures for the preferred stock represented a redemption in form only, as the substance of the transaction was a dividend. The stockholder's equity interest in the corporation was unaltered by the exchange.

20. Section 317(a), Appendix A of this Brief p. 37.

Section 302[21] established the treatment which was to be accorded the preferred shareholders in the redemption. Section 302 provides that "exchange" treatment is to be accorded the stockholder where his equity interest is eliminated. Thus, the preferred stockholder was required to recognize gain or loss on the exchange. This treatment was affirmed by the Treasury's ruling issued to Fidelity-Philadelphia Trust Company prior to the exchange.[22]

Section 311(a)[23] dealing with the effect of a redemption on the issuing corporation provides that realized gain or loss to the corporation on the exchange is not to be recognized. The fact that a gain or loss is not "recognized" does not mean that it is not "realized" and that the value of the consideration given (the preferred stock worth $33 per share) is not to be equivalent to the value of that received in an arm's length transaction.[24] Furthermore, Section 311(a) does not provide that an *expense* such as discount cannot arise from an exchange transaction and subsequently be deducted.

The concepts of gains or losses and business expenses are totally severable and distinct concepts and are not to be confused as the petitioner and the Court of Claims, in its various decisions, have done.

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21. Section 302, Appendix A of this Brief p. 35.

22. R. 17-21.

23. Section 311(a), Appendix A of this Brief p. 37.

24. The exchange was a genuine arm's length transaction. The preferred shareholders no longer retained an equity interest nor a voice in NAD's operations. As a result they did not have an interest in the future profitability of NAD beyond that interest common to all creditors of NAD. Therefore, the opposing interests of the retiring stockholders and NAD resulted in an arm's length transaction. This factor was undoubtedly a consideration facing Congress when it extended a capital gain rather than ordinary income treatment to a section 302(a) redemption.

The petitioner contends that the exchange in this case was a reorganization and throughout his brief refers to it as a recapitalization. He attempts to analogize this case to those controlled by the reorganization provisions.[25] NAD believes these references only tend to cloud and confuse the issues. The petitioner at no point clarifies whether he is talking about a tax-free reorganization as described in Section 368(a)(1)(E) or a taxable financial reorganization. If he is referring to the latter it has no relevancy to a determination of the issues in this case nor does it aid in resolving those issues. If he is referring to the former he appears to be wrong as evidenced in great part by the conclusion in the Treasury's ruling letter issued prior to the exchange which stated that the exchange was a redemption and not a tax-free Section 368(a)(1)(E) recapitalization.[26]

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25. See Petitioner's Brief p. 16. Rev. Rul. 59-387, 1959-2 Cum. Bull. 56 involved the exchange of debentures and common stock for outstanding preferred stock. Consequently, the preferred stockholders retained an equity interest as common stockholders. In *Claussen's, Inc.* v. *United States*, 469 F.2d 340 (5th Cir. 1972), a case relied upon by petitioner, the outstanding common stock was exchanged for debentures plus the corporation's new common stock in direct proportion to the stockholder's original equity interest in the corporation. The Court of Appeals in the case at bar appropriately distinguished *Claussen's, Inc.* and in so doing stated:

> The court [in *Claussen's, Inc.*] held that the common stockholder's equitable posture relative to the corporation and to one another after the exchange was substantially the same as it was before the exchange, and hence no bond discount arose. Pet. App. B at 65 n.7.

26. A reorganization is described in Section 368 of the Code. Included in the definition of a reorganization is a recapitalization. Section 368(a)(1)(E). This term is not defined in the Code, and the accompanying regulations in defining a recapitalization (Reg. Section 1.368-2(e)) set forth several examples, all of which involve a corporation giving equity secur-

(Continued on following page)

In view of the fact that the exchange was determined to be a redemption the preferred stockholder was required to accept the fair market value of his preferred stock ($33.00) as representative of the fair market value of the debenture ($33.00).[27] Consequently, the preferred stockholder was required to report a gain or loss based on the difference between his basis in the preferred stock and the fair market value of the debenture ($33.00). He thereafter held the debenture with a basis equivalent to the fair market value of the debenture or $33.00 per debenture. (R. 21) Because the face amount of the debenture was $50.00 and the holder was to receive $50.00 at maturity, the $17.00 difference between the fair market value or issue price of the debenture and the $50.00 face amount represented interest income to the holder. Prior to 1969 this discount or interest income was recognized by the holder upon the maturity of the bond.[28] Since this treatment was proper for one party to this transaction, the preferred stockholder, it was likewise proper

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Footnote continued—

ities in the exchange. It is important to note that Reg. Section 1.354-1(d) suggests that when one is not within the terms of a reorganization in the exchange of debt for outstanding equity securities, then a redemption under Section 302 is involved. Reg. Section 1.354-(1)(d) ex. 3 states:

> C, a shareholder in Corporation Z . . ., surrenders all his stock in Corporation Z in exchange for securities in Corporation Z. . . . [S]ection 354 [that section which controls the tax treatment of a reorganization] does not apply. See, however, Section 302.

27. The Commissioner has criticized NAD for not having offered better evidence regarding the fair market value of the debentures. However, NAD has offered the best evidence possible. The debentures were not offered to the general public but were used to redeem the preferred stock trading in the over-the-counter market for $33.00 per share on the date of the exchange. (R. 160, 167)

28. Since 1969 the holder has been required to recognize discount ratably over the life of the bond. Section 1232(a)(3)(A).

that NAD should be viewed as having issued the debentures for the fair market value of the stock ($33.00), and that the difference between that fair market value and the face value should be amortizable interest expense and therefore deductible.[29]

The fact that NAD's exchange of the debentures for the preferred stock should be viewed as a redemption or "exchange" transaction finds further support in *Reef Corporation* v. *Commissioner*, 368 F.2d 125 (5th Cir. 1966), cert. denied 386 U.S. 1018 (1967). In the *Reef* case, the Court pointed out that in a tax-free recapitalization involving an exchange of common stock for common stock which was accomplished at the same time as an exchange of debentures for preferred stock, an additional separate event for tax purposes involving the exchange of the debentures for the preferred stock occurred. The Court there stated:

> to effect the intention of Congress manifested in the Code, we must separate this transaction into its two distinctly separate functional parts. The test of whether events should be viewed separately or together as part of a single plan is not temporal but is functional. See *Davant* v. *Commissioner of Internal Revenue*, 5 Cir. 1966, 366 F.2d 874. Applying this test to the instant case, it is clear that the redemption and the change of corporate vehicles must be viewed as separate and distinct events. Cf. *Bazley* v. *Commissioner of Internal Revenue*, 1947, 331 U.S. 737 . . . . *Id.* at 134.

This view clearly explains NAD's position in this case that the redemption was separate and distinct from the tax-free recapitalization of common-for-common which occurred. (R. 57)

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29. Reg. Section 1.61-12(c)(3), *supra*.

IV. NAD's Discount or Interest Expense of $17.00 Per Debenture Was Incurred Because of NAD's Need to Borrow $33.00 from the Preferred Stockholders in Order to Purchase Their Stock, and the $17.00 Was Not a Loss on the Exchange.

"Losses" and "interest deductions" are not synonymous concepts in the Internal Revenue Code. They are technical terms. Yet the petitioner argues that the use of the terms "loss" or "interest" presents an abstract or verbal issue.[30] Congress, on the other hand, has found it necessary to define interest expense deductions and gains and losses under separate subchapters of Subtitle A of the Internal Revenue Code.[31] Gains and losses result from sales wherein the appreciation or depreciation in value of property held for a period of time is recognized. An interest expense is best defined as "*compensation* for the use or forbearance of money."[32]

Judge Phillips, writing the opinion for the Court of Appeals, clearly recognized and explained the fact that "loss" and "interest expense in the form of discount" were separate elements in a transaction and he attempted to explain the confusion experienced by the Court of Claims in its cases.[33] He analogized the NAD situation to one where the corporation sold its $50.00 debentures for $33.00 to obtain the cash to redeem the outstanding preferred stock then selling for $33.00 per share. In turn this cash was used for a redemption of the outstanding preferred

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30. See Petitioner's Brief pp. 12-13.

31. Gains and losses are defined in Section 1001 of Subchapter O and are dealt with in other provisions of Subchapters O and P. Interest expense is a deduction defined and allowed in the computation of taxable income under subchapter B.

32. *United States* v. *Midland-Ross Corp.*, *supra*.

33. Pet. App. B 55-58.

stock, the corporation paying out $33.00 in cash per share to the preferred stockholders. This, said Judge Phillips, would undoubtedly result in a $17.00 discount. In his opinion to allow a deduction for discount in that situation and not in the case before the bar was to allow form to control over substance[34] and effectively deprived NAD of those deductions which Congress had intended should be granted under the Code.[35]

Judge Phillips' analysis of what took place was thorough and complete. He noted that a $17.00 discount on a $50.00, 18 year debenture resulted in only an additional 1.9 percent effective interest rate per year. This additional 1.9 percent was a reasonable addition to the 5 percent stated interest on the debentures, in light of the financial status of NAD at the date of the exchange. His analysis also made clear the distinctions between the concepts of gain or loss, on the one hand, and interest expense, on the other hand. Being able to separate these concepts, he found that interest expense could be incurred in the form of bond discount in an exchange resulting from a redemption where gain or loss might be realized.[36]

Other courts have also recognized that in an exchange of debt securities for stock or other debt securities original issue discount may arise, and these cases all clearly stand

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34. Pet. App. B 53-54.

35. To deny similarity in treatment of these two situations would result in a corporation embarking on an expensive set of transactions in order that it might clearly establish a deduction which Congress undoubtedly previously granted.

36. Gain or loss will be "realized" on most exchanges, however, it may or may not be "recognized." Realized gains and losses represent a concept separate from recognized gains and losses. See Sections 1001 and 1002.

for the proposition that discount is predominately a creature of economic fact.[37]

V. The Decisions and Analysis of the Court of Claims Relied upon by Petitioner Are Founded on Confusion and Erroneous Conclusions.

Erie Lackawanna R. R. Co. v. *United States, supra,* is the cornerstone of those cases supporting the petitioner's position herein as well as the petitioner's analysis of the exchange transaction. However, the Court in *Erie Lackawanna,* also relied upon by the dissent in the case at bar, fails to set forth any reasons for reaching the ultimate conclusion that:

> [s]ince plaintiff issued its stock for $100 per share and carried the stock on its books at this amount, this is the amount which should be used to determine whether discount has arisen. *Erie Lackawanna R. R. Co.* v. *United States, supra* note 15, at 429.

Apparently the conclusion is further reflected in the statement that plaintiff "lost nothing as a result of the transaction." *Erie Lackawanna R. R. Co.* v. *United States, supra* note 15, at 430.

The petitioner refers to these conclusions and the result reached by the Court of Claims as the "arithmetical equiva-

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37. *Atchison, Topeka and Santa Fe R. Co.* v. *United States,* 443 F.2d 147 (10th Cir. 1971) where the court at page 153 said it was necessary to look to "economic and business reality" to determine if discount arose; in *American Smelting and Refining Co.* v. *United States, supra* note 7, at 885 the court stated:

> We believe that discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash.

See *Nassau Lens Co.* v. *Commissioner, supra; Southern Fertilizer & Chemical Co.* v. *Edwards,* 167 F.Supp. 879 (M.D. Ga., 1955), and *Industrial Development Corp.* v. *U. S.,* 56-2 USTC, ¶10,066 (N.D. Ill., 1956).

lence" theory.[38] To point up the fallacy in such a theory let us assume that "A" buys a machine for $55.00 in 1960 and sells it to "B" in 1965 for $50.00 cash. In 1970 "A" repurchases the same machine from "B" for a $45.00 note with an additional $5.00 interest to be paid. "A" has regained his machinery and he will pay "B" a total of $50.00, the same amount or arithmetical equivalent of what "B" paid "A" five years earlier. However, the economic realities and the surrounding facts, i.e., the cost of the use of "B's" money and the decline in the market value of the machine, point up the fact that an arithmetical equivalence formula is an approach used only when one fails to make an analysis of a transaction and the economic realities attached thereto.

The basic fallacy inherent in the reasoning of both the Court of Claims and petitioner is that they fail to distinguish between a debt obligation, which is reflected as a long term liability on the books of the corporation, and an equity interest which is reflected in a capital account of the corporation. From the accounting viewpoint a corporation's capital accounts are those representing contributed or paid-in capital. The capital accounts do not include borrowed funds which the corporation must repay at a fixed maturity date, with set sums of interest to be paid at regular intervals prior to maturity.[39]

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38. Such a phrase is difficult to comprehend but we assume in the context of the facts of the case at hand that it means something like an apple equals an orange, or a debenture equals a share of preferred stock. But, in truth we believe this approach is employed as an easy means of avoiding the otherwise difficult task of analyzing the economic realities of a given case and recognizing the tax consequences involved in a transaction.

39. See generally Section 21 of Wilcox, Kell and Bedford, *Accountant's Handbook* (5th ed. 1970), p. 21.1.

The confusion apparent in the *Erie Lackawanna* case is further compounded by a proper reading of the *Union Pacific* case[40] which the Court of Claims relied upon so heavily in arriving at its decision in *Erie Lackawanna*. The *Union Pacific* fact situation was the converse of that in *Erie Lackawanna* and the tax involved was the World War II excess profits tax. In *Union Pacific*, the taxpayer corporation substituted common stock for its outstanding convertible debentures.[41] The value of the debenture in the hands of its holder constituted a liability to the issuer taxpayer corporation in the face amount of the debenture. The corporation would some day have to pay this face amount in full. Therefore, the exchange of common stock for the outstanding debentures constituted a satisfaction of the debt in its face amount. This is not analogous to the converse situation before this Court where NAD had outstanding preferred stock with a $50.00 par value which it never would have been required to repay.

It should be noted that the *Union Pacific* case, *infra* note 40, involved convertible debentures. The issuance of a convertible debenture does not yield a closed transaction because from the date of issuance of the debenture to the date of conversion the holder has the option to convert the debenture into stock. Thus, it might be proper to tie the issuance of the convertible debenture to the subsequent conversion into stock and treat it as one transaction as the conversion was clearly anticipated when the debentures were originally issued. The Court in *Union Pacific* felt that for this reason the value of the stock was

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40. *Union Pacific R.R. v. United States*, 401 F.2d 778 (Ct. Cl. 1969), cert. denied 395 U.S. 994 (1969).

41. Reg. Section 1.368-2(e)(1) indicates that this form of a transaction is a recapitalization which will constitute a reorganization.

equivalent to the face amount of the debentures. This was probably true, but NAD's transaction was entirely different.

The petitioner, relying on the decision in *Erie Lackawanna*, has attempted to treat the sequence of events in NAD's transaction as one. He has argued that the $50.00 received by NAD in 1946 should be viewed as the same $50.00 ultimately received by the debentureholder at the maturity date.[42] He totally ignores the $33.00 market value of the preferred stock on the date of the exchange. Such an approach is interesting because it is certain that had the preferred stock had a fair market value of $60.00 as of the date of the exchange the preferred stockholder would not have accepted the $50.00 face amount debenture. In any event, the sale of stock is generally considered to be a closed transaction as is the redemption of stock. Therefore, the petitioner's contention that each of these transactions should be treated as part of a continuing series of transactions is without statutory or factual support. An analysis of the events shows that they are separate and should be viewed as such.

In 1946 and subsequent years NAD issued preferred stock for cash or similar property. The par value of this stock was recorded on the books of NAD in a stockholders' equity account the preferred stock account. In 1957 NAD issued debentures in the face amount of $50.00 for each share of preferred stock then outstanding and trading for $33.00 per share. It was financially impossible for NAD to use cash to redeem this stock.[43] Due to the poor financial condition of NAD and the risk involved in accepting NAD's debentures it was unlikely that the preferred stockholders would accept debt obligations equal

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42. See Petitioner's Brief p. 28.

43. See note 11 of this Brief.

to the $33.00 fair market value of the preferred stock and paying a mere 5 percent interest rate. To resolve this situation, NAD was willing to pay additional interest in the form of discount on the debentures. The economic realities of the situation had to be recognized. While the preferred stockholders might have accepted $33.00 cash in hand for their stock, they would not have reloaned that money to NAD without requiring NAD to pay for the use of the money, particularly in view of NAD's financial status at that time.[44] Therefore, the extra $17.00, the difference between the face amount of the debenture and the fair market value or issue price of $33.00, was an additional cost which NAD paid for the use of the funds.

The petitioner has cited *Old Mission Co.* v. *Helvering*, 293 U.S. 289, 292-293 (1934)[45] for the proposition that where bonds are issued by one corporation and held by an affiliate with which it files a consolidated return no deductible interest expense or discount attributable to those bonds can arise. The actual basis for the decision in *Old Mission* was that the discount or interest could not be deducted in view of the fact that the affiliate would not have had to recognize the discount or interest as income until the maturity date of the bonds while the issuer of the bonds would have been deducting the interest expense or discount over the life of the bonds thereby creating an unwarranted interest deduction between affiliates. NAD fails to see the significance of this case as it relates to the issues in the case at hand.

Another case inappropriately cited by the Commissoner is *Great Western Power Co.* v. *Commissioner*, 297 U.S. 543 (1936). The Commissioner contends that this

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44. See note 11 of this Brief.

45. See Petitioner's Brief p. 13.

case is a bald rejection by the Supreme Court of the "contrary to fact analysis" made by Judge Phillips in the decision of the Court of Appeals.[46] Judge Phillips felt that the true substance of the case could best be viewed when a realistic economic analysis of the facts surrounding the exchange was made. The *Great Western* case involved an exchange of bonds for bonds. The question presented was *when* the issuer could deduct the expense incurred. The accrual basis taxpayer corporation argued that if the Court viewed the exchange as having been made with cash then the expense was deductible currently. The Court, however, said that in determining *when* the expenses were deductible one could not use a cash substitution test and that in this case the taxpayer corporation had to amortize and deduct the expense over the life of the bonds. The issues in *Great Western* are not similar to those in the case at hand. In the case at bar the question is not *when* the expense is to be deducted but rather whether interest expense was incurred. Moreover, it is not a question of timing or cash basis accounting versus accrual basis accounting as it was in the *Great Western* case.

The petitioner quotes *Penfield* v. *Davis*, 105 F.Supp. 292, 311 (N.D. Ala., 1952), affirmed, 205 F.2d 798 (5th Cir. 1953), stating that "from the standpoint of the preferred shareholders, the conclusion appears inescapable that their interest 'was fairly reflected in the highly equivalent characteristics of the debentures into which the preferred [stock] was converted.'"[47] Yet the petitioner fails to recognize that under the 1939 Internal Revenue Code, which controlled the *Penfield* case, there did not exist a provision which specifically stated that the exchange of

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46. See Petitioner's Brief p. 27.

47. See Petitioner's Brief p. 15.

debt securities for outstanding equity securities was a redemption such as now exist in Sections 317(a) and (b) and 302 of the 1954 Code. Prior to the adoption of these sections the courts were without guidelines for determining what constituted a redemption as opposed to a reorganization. As a result, cases such as *Penfield* caused confusion, as the courts attempted to determine how the situation should be handled. The 1954 Code made massive changes in this area, clearing up the confusion which existed, as explained in *Reef Corporation* v. *Commissioner, supra* p. 22, at 134-135 where it is stated:

> In 1954 Congress completely overhauled the sections of the Code detailing the tax consequences of many types of corporate transactions. Grouped together by Congress were the sections dealing with corporate distributions and adjustments, including the sections dealing with partial liquidations, stock redemptions (complete or partial), and corporate reorganizations. As we said in *Davant* v. *Commissioner of Internal Revenue*, 5 Cir. 1966, 366 F.2d 874 at 879: 'In order to effectuate the intent of Congress the dividend, liquidation, redemption and reorganization sections of the Code must be examined and viewed as a functional whole.'
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> Prior to 1954 Congress had not specifically provided for the tax treatment of partial liquidations or redemptions. This problem had been handled by judicial decisions which caused 'unwarranted' taxes and in others allowed taxpayers to 'avoid' proper taxation. To correct this situation, Congress enacted a comprehensive set of rules governing the complete and partial redemptions of a stockholder's interest in a corporation. Section 302.

> In the instant case the only way to protect the statutory intent of Congress is to test the redemption of stock by the provisions of section 302. A similar result as to the stockholders comes from applying sections 368, 354 and 356. But this method may not always reach the same result and in the instant case would cause an improper result with regard to the corporation. Since the reorganization and the redemption are functionally unrelated in this case, the redemption should be tested by the standard Congress has laid down in section 302.

A test of the facts surrounding NAD's transaction against the standard of Section 302 shows that a redemption occurred and that the preferred stockholders were required to use the fair market values for the debentures and preferred stock in recognizing gain or loss. If the stockholder in the exchange is required to use fair market value, NAD should also.[48] It appears to NAD that the petitioner wishes to completely avoid discussion of a redemption in his brief in an attempt to reinstate the pre-1954 Code decisions even though Congress specifically legislated in this field to clear up the confusion existing under the 1939 Code as reflected in cases such as *Penfield*.

Similarly, petitioner contends that *Helvering* v. *Southwest Corp.*, 315 U.S. 194 (1942) requires the present case to be viewed as a reorganization.[49] As has just been noted, however, the 1954 Code introduced new concepts in the area of corporate redemptions and *Southwest Corp.* is another case decided prior to Congress' introduction of these concepts in the 1954 Code. Further, and as pointed out previously, the term "capital structure" in an accounting

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48. See p. 21 of this Brief.

49. See Petitioner's Brief p. 24.

sense does not include long term liabilities but rather includes only contributed capital of the equity owners.[50] Therefore, the reference in *Southwest Corp.* to a "reshuffling of the capital structure", which petitioner attempts to attribute to NAD's transaction, is inappropriate since a redemption of a portion of the capital structure with debt obligations cannot be included in such a phrase.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Court of Appeals should be affirmed.

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50. See p. 26 of this Brief.

CERTIFICATE OF SERVICE

I certify that on the 27th day of December, 1973, three copies of the above and foregoing Brief for the Respondent were sent postage prepaid, by regular United States mail in accordance with Rule 33 of the Rules of the Supreme Court of the United States, to the Honorable Robert H. Bork, Solicitor General, and Stuart A. Smith, Assistant to the Solicitor General, Department of Justice, Washington, D.C. 20530, and one copy each was similarly sent to Scott P. Crampton, Assistant Attorney General, and Meyer Rothwacks and Ernest J. Brown, Attorneys, Tax Division, Department of Justice, Washington, D.C.

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Attorney for Respondent

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 163. [INTEREST.] (a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * *

Sec. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) General rule—If a corporation redeems its stock (within the meaning of Section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions Treated as Exchanges—

(1) Redemptions Not Equivalent to Dividends —Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially Disproportionate Redemption of Stock—

(A) In General—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) Limitation—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) Definitions—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of Redemptions—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of Shareholder's Interest—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

* * * *

Sec. 311. TAXABILITY OF CORPORATION ON DISTRIBUTION.

(a) General Rule—Except as provided in subsections (b), (c), and (d) of this section and Section 453(d), no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock of—

(1) Its stock (or rights to acquire its stock), or

(2) Property.

* * * *

Sec. 317. OTHER DEFINITIONS.

(a) Property—For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) Redemption of Stock—For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

Sec. 1.61-12 [as republished in T.D. 6500, 25 Fed. Reg., Part 11, pp. 11402, 11442-11443] Income from Discharge of Indebtedness.

* * * *

(c) Sale and Purchase by Corporation of its Bonds. . . .

* * * *

(3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds.

* * * *